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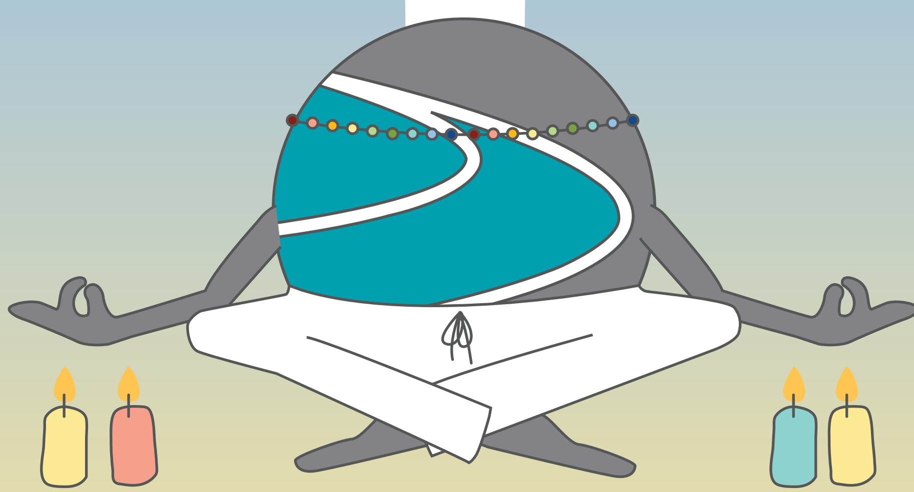

More Time to be Mindful?

AUGUST 2018 — An absorbing topic emerged this week when President Trump advocated that the SEC study the viability of companies moving away from announcing quarterly earnings—if so desired.

The argument generally involves the idea that an unhealthy preoccupation on quarterly earnings hurts the economy because it over-focuses management on short-term projects and detracts from the funding of long-term projects that are crucial to our wellbeing. At least as Americans.

I really want to agree with the idea, but our experience suggests that the market as a whole sniffs out and differentiates those who invest intelligently, those who play the quarterly earnings game, and those who in the end truly waste other people's money. In other words, investors figure out with some awful head-fakes what really is happening. It can be hopelessly unclear in the short-run, but as Mr. Graham noted and it still applies: in the long-run the scale comes out. We have WorldCom, Enron, Theranos, and...Tesla? And we have Amazon, the entire medical and pharmaceutical industry, and the billions raised in Silicon Valley on hopes and dreams and schemes that occasionally produce Google. So is it really going to move the needle? I doubt it.

But, why the hell not try to get off the quarterly games? To the critics, we would note that if our financial system somehow moseys along without what seems to be a functioning system of agreed upon accounting standards and a nearly indifferent sense of valuation, then why can't we have a system evolve to where companies can choose to report every 3 or 6 months? Investors will gravitate toward their levels of comfort. If you have "done the work," you should be happy to have the market closed for six months and not be bothered with daily pricing and quarterly hand-holding through "updated guidance" and other bromides from management. Some need it and will gravitate toward their perception of less uncertainty. In a world with almost 3 billion smart phones connected to that Al Gore-created do-hickey, how is it possible to suggest that we need "more" information?

The difference between the legal and academic world versus the real world, is that people in the former think the two are the same thing while those in the real world disagree vehemently. To argue that the quarterly reporting game as presently practiced is not a huge burden and distraction at best for public companies is ignorance. To suggest it doesn't affect corporate behavior is ditto. To suggest that we have not seen hundreds of utterances in our conference room that in some way relate to a rational corporate action not being taken because they are worried about short-term appearances to "the sell-side," or their stated guidance, would not reflect the real world.

The "quarterly parade" also extends to the investment management world. Bring the investment manager in for quarterly meetings and he will be dragged into investing with quarterly thinking, he will then exert pressure on companies to deliver quarterly, and finally the companies will then turn to compensation consultants and bend common sense into shorter-term compensation schemes. And that is how it works in the real world.

And since the overwhelming consensus is toward passive investing, why should anyone care anyway if you are going to just buy the market and let third party advisors vote proxies for you?

Conveniently for those in political power, it ignores a big elephant in the room. We currently have a political and regulatory system that, regardless of which party is in power, seems obsessed with change and picking winners and losers. Nothing inhibits spending billions of dollars in the form of long-term investments than a high probability of its value being eviscerated by the stroke of a bureaucratic pen or a tweet. Changing THAT would matter more to investors than would a change in quarterly reporting.

But most importantly, and in the words of the seemingly departed Jack Handey, think not what you can do for the common good, but think of us! WHAT A GREAT IDEA FOR CSC! The amount of time wasted in quickly scouring legal and PR-advised announcements is incalculable. An "investor" is forced to absorb hundreds of pages of press releases, presentations, earnings call transcripts, and SEC filings in the hope or fear of finding or missing "the clue" that will provide "the edge". Of course, all of this work more and more can truly be improved by automated services and AI. More thoughtful and paced work? More thinking versus acting? More thinking and acting like an owner versus a capuchin trained to dance quarterly? Sign us up.

Moving on to things Cove Street at roughly the halfway mark of the year, I think this recent quote works well on internal thinking and on markets at large: "We also found that valuations in the second quarter and so far in the first half of the year have not mattered. If a manager is focused on valuation factors, that has been the kiss of death."

Yup. I can talk about how our portfolios are concentrated and how we are long-term investors who thrive in the land of the less traveled and less efficient—and thus people are clearly not paying us to dance the tango with an index in the short-run. I can clearly state that 2008 was REALLY a lot worse in that losing money is palpably painful, versus merely underperforming. I can also point you to a Warren Buffett/Jamie Dimon Op-Ed in the New York Times decrying the quarterly myopia of the corporate/investment world.

But, so what? It doesn't diminish the frustration associated with going through the inevitable 18 months out of 7 years where the hard hit ground-ball does not go up the middle, it gets picked off by a second baseman with a .189 batting average. Or the pain you would feel if you woke up in a bizarre dis-utopian world in which your portfolio had taken up the pace of play of a World Cup match.

Whining aside, our problem in recent quarters is less about "the environment" and more about us. And simply said, our largest positions have done diddly and when they represent nearly 50% of your portfolio, it's harder to move the needle.

And that is the good news…now. Intrinsic values in our portfolio have generally increased, prices have generally flat-lined, and thus our price to value spring has coiled. In most cases, there is nothing wrong in the businesses in which we invest. The problem is the damn stocks, which we fully understand are part of our responsibility. Having a good ear to the ground and having sense of where in the distance the herd may be heading is part of being a good public markets investor. That is because the time horizon of the overall investment community is not nearly as long as is the portfolio manager's willingness to invest in and hold onto a business solely on business characteristics. Every great idea has an inflection point where it starts to become strained and somewhere around the third year of which a stock is "far from killing it" is that number in the investment business. Just is. When people talk about our edge, we often argue that part of it is our cultural temperament to accept time horizon risk. But, as one can learn the hard way, you really find out who is with you and who isn't as you explore this process.

As was somewhat humorously noted in a recent Grant's Interest Rate Observer on the passing of long time value investor Michael Harkins, "Levy, Harkins achieved a stellar 39-year record—they compounded their investors' fund at the rate of 12.6%, net of fees—there were bumps on the road to prosperity. In one such time of trial, Michael told his friends that his mother had fired him and shifted her investment account to Fidelity. "And that's not the worst of it," said Michael. "The worst of it is that I gave her the money.""

What now? You should be giving us more or new money. I am not sure I can quantitatively produce any sort of work right that would suggest to the reader that on an absolute basis, equities in general, and small cap in particular, are cheap on an absolute basis. But, I can make a really strong case on a relative basis that you should be giving us money now, as we are simply not this stupid, and we do have some pretty good math regarding historical periods like this…and what subsequently transpires. And as one Mrs. Bronchick recently noted on a very early and still dark Saturday morning, "It's a bottom when you finally start whining to me." We recently did a presentation that consisted of three pages: the first was our performance when you hired us, the second page was our performance two years later, and the third page was entitled, "What Has Changed Since You Hired Us?" It was blank.

So, for those readers whom I half talked out of giving us money two years ago, please re-read the previous paragraph. Paul Hinkle, our Chief Client Officer, is waiting to take your call.

Or, as Masayoshi Son (of God), CEO of the Japanese Everything Fund also called Softbank and apparently the inspiration for whatever Elon Musk wakes up and feels every morning, "I ask investors to trust my instincts. The premonition that something will work bubbles up inside me," he said. For startups, he said, cash flow was less important than leadership and a stellar business model. "You have to feel it, like in 'Star Wars'—feel the force."

You don't have to "feel" value; you have to see it through disciplined work…and sometimes wait longer than you think necessary. A classic example in our small cap portfolio was Belmond (Ticker: BEL), a deeply undervalued collection of iconic hotel properties that has SLOWLY become a branded portfolio. We waited…four plus years…and the Board finally put the company up for sale. From an $11 cost, we think we will see $18 to $20. A pretty decent return given the limited risk of boredom, and it delivered on the latter until a week ago. Painful, but that is how it works sometimes. And it highlights the beauty of new clients: there is always someone who is not mad at you.

We continue to add to positions in broadcasting as we think the consensus is wrong. In reality, political ad spending did not go away with the Trump Tweet and revenue has become increasingly contractual versus spot-based. In addition, there are tremendous merger synergies available to what is grindingly moving toward a new regulatory environment where Google and Facebook are the true competition, not station number 3 and 4 in a market.

We continue to buy the crap out of ViaSat (Ticker: VSAT), as our research suggests people are completely missing the growth in the defense business which can now be reasonably valued north of $40 per share. Also, we have never seen worse sell-side coverage in attempts to judge an outdated subscriber add/subtract model versus a "we spent $600mm on Satellite II, and are on track for $1.2 billion of value—but no movement to date."

We bought more of Compass Minerals (Ticker:CMP), which improbably has not been activist-ed yet. Politics aside, they have a solid regional monopoly on mining road salt, a nearly self-contained Brazilian agriculture business and a profitable specialty US ag business. The stock is $61; sum of the parts $90. It snowed a lot last winter and improved results come with a seasonal lag. Management has missed every target that a PowerPoint can create. Easy pickings.

In our All Cap portfolio, we recently bought DowDupont (Ticker: DWDP). History doesn't repeat but it does rhyme from time to time, and CEO Ed Breen rhymes with Tyco in our ears. (Tyco was a very successful prior holding divided up by Ed.) This beast is being split into three parts, and we think the sum of the parts is close to $90. But it's messy, and taking time, and the aforementioned Breen is buying stock.

So, there is stuff to do that is not related to Elon Musk, a unicorn, a factor model, or inclusion in a popular index. Carefully selecting idiosyncratic risks and factors and assembling them into a curated portfolio seems to us a more rational way to invest money than is investing for the future based upon back-tested variables that almost by definition will become mean-reverting in the future as well-marketed money pours forth. For if we have learned anything over 30 plus years as an active practitioner, as well as a dorky student of history, and human behavior, cycles in all their forms are still with us within financial markets. As Nobel laureate Niels Bohr once joked, "prediction is very difficult, especially if it's about the future;" but to ignore the probability that things change is also foolhardy.

We think the Land of Deplorables defined as "not in an index" is a field worthy of exploration. Things that cannot be easily quantified and factored like management competence, off balance sheet assets, Board composition, and "change" remain real things that can only be identified through disciplined work and exploited in a concentrated portfolio. And we think recent pronouncements by the compliance department of a REALLY LARGE investment bank that will soon forbid the purchase of "stocks trading at less than $5 or with less than a $300mm market cap" (even when it comes from third party investment managers their clients have chosen), is really a good sign for future value endeavors.

Moving to the world at large, what really bugs us about the Trump administration's tariff war is that it is as self-defeating and as dumb as the last administration's attempts to pick winners and losers. "How this will play out is idiosyncratic to any given product and unique to each supply chain," said Daniel Rosen, partner at the economic research firm Rhodium Group. "Nobody can honestly claim high confidence that they understand what the overall impact will be. You may as well project the weather on a Tuesday afternoon a year from now."

What worries us is currency movement. Nothing is larger and more leveraged than foreign currency markets and markets that use a lot of leverage tend to move in a hurry and in ways that are difficult to predict. And cause pain. The bigger issues in financial markets over decades have been remarkably correlated with currency movement and while it might be easy to ask out loud who truly cares about the Turkish Lira, contagion remains a distinctly human behavior that has not been eliminated by algorithms.

And lastly, interest rates have moved higher, albeit mostly on the short-end. There is a lot of interesting history as to the debate about whether higher interest rates are per se bad for equities. (www.covestreetcapital.com/facts-can-be-very-different-than-the-narrative/) Since 2007, the thinking "in the market" was that deflation was the dreaded scenario and ergo some lift in rates is good. We can recall other times, when the exact opposite was the case as people worried that rising rates means inflation. In the meantime, the Fed is moving short-rates higher and the "market" is holding down the long-end. It won't last forever, and the longer it stays flat or inverts, the worse the historical record is for the economy and financial markets. And we would reiterate that the combination of higher rates and weird currency movements tends to reflect poorly on the desire of the world to extend credit, as credit remains the most fickle and inexplicable of friends. But we recognize that Stein's Law obeys Davie's Corollary: Things that can't go on forever won't, but they can go on for a lot longer than you think."

We close with an old quote from what used to be known as Leucadia, another old school value shop that was subsumed by age, frankly poor results, and Jefferies. For the record, we are a lot younger and just got even younger with the addition of Andrew Leaf, research analyst. After Georgetown and three-plus years in investment banking and private equity, he joins us as the first of the third generation of the Cove Street investment team.

But getting back to the quote that still rings the bell here because it is so different from any number of really cool, growthy things that sounded impossibly cool at the time and then years (or months) later seemed impossibly stupid and embarrassing. (Cough…Crypto)

> We tend to be buyers of assets and companies that are troubled or out of favor and as a result are selling substantially below the values which we believe are there. From time to time, we sell parts of these operations when prices available in the market reach what we believe to be advantageous levels. While we are not perfect in executing this strategy, we are proud of our long-term track record. We are not income statement driven and do not run your company with an undue emphasis on either quarterly or annual earnings. We believe we are conservative in our accounting practices and policies and that our balance sheet is conservatively stated.

No matter what else is popular, the above scripture just doesn't seem to go out of style here.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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